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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Simplification of the Depreciation Prescription Process	)	CC Docket No. 92-296
	)	

REPLY COMMENTS

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SUMMARY

BellSouth demonstrates herein that the Price Cap Carrier Option is the only option that will both simplify the depreciation represcription process and result in more accurate depreciation. BellSouth proposes a PCCO that will continue to rely on existing depreciation methodologies. Ample data will be provided to permit meaningful participation in the depreciation prescription process by interested parties and state commissions. Following Notice and Comment procedures, the Commission will prescribe appropriate depreciation rates for each carrier. These procedures will simplify the process and will give appropriate weight to the informed judgment of carrier management as to the remaining lives of existing plant.

Criticisms of the PCCO are both exaggerated and speculative. "Manipulation" of depreciation rates to avoid sharing is contrary to a price cap LEC's self-interest and would be easily detected and corrected if attempted. Adequate controls exist to protect ratepayers from any attempted manipulation.

The "range" options are more complex than the PCCO and will produce less accurate depreciation. Unless the prescribed ranges are wide enough to accommodate individual carrier characteristics, the resulting force-fit into the prescribed ranges will inevitably result in less accurate depreciation than the PCCO. The Commission's goal of

simplification would also be sacrificed, as carriers would be required to seek individual treatment to correct the resulting reserve imbalances.

There is no support in the record for the depreciation schedule option. The record also reflects that consideration of changes in accounting for cost of removal and salvage should be deferred to a separate proceeding.

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REPLY COMMENTS

BellSouth Telecommunications, Inc. ("BellSouth") offers the following reply comments in the captioned proceeding in accordance with the Notice of Proposed Rulemaking ("Notice"), FCC 92-537, released December 29, 1992.

In its Initial Comments, BellSouth commended the Commission for its efforts to simplify the depreciation process. BellSouth supported Option Four, the Price Cap Carrier Option ("PCCO") for carriers subject to price cap accuracy and simplification.[2] In fact, the PCCO will improve accuracy in addition to simplifying the depreciation process.

Properly designed and implemented, the PCCO will produce more accurate depreciation than the present system. The present system places undue emphasis on historical data. In the present environment, emerging technologies permit carriers to reduce costs and offer new services by replacing older technology equipment before that equipment is physically worn out. This makes technological obsolescence more important than physical obsolescence in matching the rate at which existing plant loses its value with the rate at which the investment is depreciated.

In an environment of rapidly changing demand and technological innovation, estimating the remaining useful life of existing plant requires the exercise of informed judgment in the areas of customer demand for new services, future competition for the provision of those services, and the location and timing of technology deployment. Carrier management is in the best position to evaluate these factors and to make economically sound decisions that will determine the remaining economic life of existing plant.[3]

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[2] State Consumer Advocates ("SCA") at 8-9; MCI at 4.

[3] SCA opposes depreciation simplification because the process involves the exercise of subjective judgment. SCA at 3. Informed judgment is always part of the process of trying to predict the future. Carrier management is in the best position to assess the future lives of existing plant.

The Commission has already held that carrier management controls depreciation through decisions on plant additions and retirements when it ruled depreciation to be an "endogenous" cost under price cap regulation. Having reached this conclusion, there is no rational basis for the Commission to substitute its judgment for that of the management of a price cap carrier regarding the remaining economic life of the carrier's assets - at least in the absence of clear evidence of abuse of that judgment by management. If carrier management is to be responsible for the results of the depreciation process, it should also be allowed to exercise its best judgment as to the remaining life of its assets.

NARUC asserts that support for the PCCO rests on "the faulty [and unstated] premise that the FCC is not prescribing accurate depreciation rates."[4] The premise is neither "faulty" nor "unstated". In its initial comments, BellSouth documented the widespread recognition that the existing depreciation prescription process is indeed "faulty", in that it results in delayed recognition of depreciation to the latter stages of an asset's life cycle.[5] The Commission itself recognized this problem when it found

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[4]NARUC at 12. See also, California PUC at 8: "[I]mplicit in this logic is the hidden allegation that the FCC is not prescribing accurate or correct depreciation rates."

[5]BellSouth at 5-12.

it necessary to amortize over $13 billion in LEC depreciation reserve deficiencies beginning in 1987.[6]

Despite this action by the Commission, BellSouth estimates that it has a current reserve imbalance of over $1.5 billion in the Metallic Cable and Circuit-Other accounts.[7] LECs are currently required to depreciate copper cable over lives that are more than twice as long as those utilized by interexchange carriers for comparable plant. The lives currently being prescribed by the Commission for new technology, such as digital switching and fiber cable, are twice as long as those utilized by major foreign telecommunications providers and by U.S. interexchange carriers.[8] The LECs are required by the Commission to depreciate fiber cable over two to six times the lives utilized by the LECs' strategic competitors, the CATV industry.[9] The assumption that there is no need for

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[6]In the Matter of Amortization of Depreciation Reserve Imbalances of Local Exchange Companies, 2 FCC Rcd 6473 (1987).

[7]BellSouth at 14.

[8]BellSouth at 10.

[9]BellSouth at 10. The only cable industry participant in this proceeding, the California CATV Ass'n. brags that the cable companies are currently upgrading their networks "using the full range of leading edge technologies", and that their ability to offer new services in competition with the LECs "will only be limited by regulatory restraints, the imagination of the developers, and the ability to find or create demand . . ." California CATV Ass'n. at 2.

depreciation reform for the LECs[10] is clearly faulty, and must be rejected by the Commission. As BellSouth demonstrates below, the PCCO can be structured to ensure accurate depreciation using a much simplified process.

II. Criticisms of the Price Cap Carrier Option are not justified.

Much of the criticism leveled at the PCCO in the initial comments can be traced to the unfortunate description of that option contained in the Notice. There the Commission stated:

> Carriers would not be required to provide supporting data for their proposed depreciation rate changes. This option would essentially eliminate all of the steps the Commission now takes to analyze the carrier's proposed

alleges that the PCCO "provides virtually no regulation at all."[14] California CATV Ass'n. states that the PCCO "affords the LECs almost complete flexibility and control over depreciation."[15] Stripped of rhetoric, the comments of opponents of the PCCO raise two legitimate issues: the need for a factual record to evaluate proposed LEC depreciation rates, and whether controls are needed to prevent "manipulation" of earnings. As proposed by BellSouth, the PCCO addresses both of these concerns.

A. <u>The Price Cap Carrier Option need not deprive the Commission and interested parties of data needed for a full factual record and meaningful participation.</u>

BellSouth has proposed a PCCO that will require carriers to maintain continuing property records. Vintage level data will continue to be used by BellSouth. Carriers will continue to use appropriate mortality data[16] coupled with company plans and future life expectations for each account. Depreciation rates would continue to be calculated using the Commission's depreciation rate formula using average remaining life, future net salvage and accumulated depreciation by account. The resulting rate will be multiplied by investment to calculate depreciation accruals.

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[14]MCI at 9/

[15]California CATV Ass'n. at 22.

[16]This will ensure adequate records to calculate survivor curve shapes, and hence the continued use of the ELG method. Compare California PUC at 4, GSA at 4, NARUC at 6.

This entire process is self-correcting and will not allow over depreciation.

When carriers propose changes in depreciation rates, which could occur annually but no less than triennially, they would file with their proposal remaining life Statements A, B and C and the parameter report, using the current formats. These schedules display the results of the depreciation process described above. For BellSouth, this procedure would result in the filing of approximately 50 pages of data.[17] With this data, the Commission and interested parties will have all the information needed to evaluate the carrier's proposals.

BellSouth proposes that the Commission then utilize Notice and Comment procedures to solicit input on the carrier's proposal from state commissions and the public. If the Commission decides that there is a need to investigate the carrier's proposal, an investigation could be instituted focused on the questionable accounts. Following the Notice and Comment period and any subsequent investigation, the Commission will prescribe appropriate depreciation rates for each account of each carrier.

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[17]This compares with the thousands of pages of data currently required by the Commission staff's 250 page FCC Depreciation Study Guide. In the represcription proceeding currently underway for the five South Central Bell states, BellSouth was required to file 1245 pages of data relating to only seven accounts. The California PUC's assertion at 2 that the voluminous LEC filings are "voluntary" is clearly erroneous for the interstate jurisdiction.

This procedure will ensure that: 1) a factual record is developed to support the Commission's prescription under Section 220(b) in compliance with the Administrative Procedures Act; 2) the Commission receives and consider the Comments of affected state commissions, in compliance with Section 220(i) of the Communications Act, and 3) the depreciation rates prescribed for each carrier reflect distort depreciation rates to manipulate earnings.[19] The continued use of the remaining life formula and ELG method, the requirements of Generally Accepted Accounting filings to minimize any attempts at manipulation. The Commission could require depreciation filings at the first of the year, to be retroactive to the first of the year. Thus, carriers would be required to commit to a level of depreciation for the year prior to having any actual earnings results for that year.

Another safeguard that the Commission could adopt is to limit the change in either the composite depreciation rate or account specific depreciation rates that a carrier could implement in a given year.[22] Although BellSouth does not believe such additional safeguards are required, they could provide the Commission and ratepayers with additional assurance against any attempts to manipulate earnings under the PCCO.

C. AT&T should not be permitted to convert the Price Cap Carrier Option into the "AT&T Option".

In its Comments, AT&T recognizes the benefits of the PCCO in reduced administrative costs, more accurate depreciation, competitive parity and elimination of distorted regulated results.[23] Having recognized these benefits, AT&T then blithely suggests that only it should be regulated under the PCCO.[24] AT&T's suggestion is blatantly self-interested, and must be rejected.

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[22]See Notice at para. 20.

[23]AT&T at 3, 5-8.

[24]AT&T at 8-10.

AT&T speculates regarding the incentives that the price cap sharing mechanism create for the LECs, but not for itself. BellSouth has demonstrated both in its initial comments and above in these reply comments that these concerns are unwarranted, and should be rejected. In evaluating AT&T's credibility, however, the Commission should look beyond AT&T's unsupported speculation to see the impact that would result from converting the "Price Cap Carrier Option" into the "AT&T Option."

their capital recovery, AT&T can enjoy the benefit of lower prices now, while saddling the LECs with an uneconomic cost structure in the future when judicial and regulatory restraints on LEC competition with AT&T are removed.[26] By claiming a monopoly on the PCCO, AT&T achieves accurate depreciation for itself, while hamstringing its suppliers and competitors with distorted capital recovery. Thus, both from the point of view of customer and competitor, AT&T's self-interest is served by opposing the PCCO for the LECs. The Commission should take these factors into account when evaluating the credibility of AT&T's comments.[27]

D. The Comments of the California CATV Ass'n. are <u>without merit and should be rejected.</u>

The California CATV Ass'n. opposes any simplification of the depreciation process. Its position is hardly surprising. As the California CATV Ass'n. freely states in its comments, cable companies are engaged in massive network upgrades to position themselves as strategic competitors to

[26]In its 1992 Annual Report at 19, AT&T states: "Because of the increasing competition with the RBOCs and the possibility of legislation that alters restrictions on

the LECs with no involvement or regulation by this Commission.[28] As BellSouth has shown above, cable companies are depreciating fiber optic cable at rates two to six times faster than the rates prescribed by this Commission for the LECs. If the Commission is concerned with the development of the telecommunications infrastructure, it should level the playing field between the LECs and the cable companies. Of the options considered in the Notice, the PCCO comes closest to leveling that playing field, although the LECs will remain at a competitive disadvantage even under that option.

In an attempt to justify its opposition to any simplification of the depreciation process, the California CATV Ass'n. offers a study in which it is alleged that there is no nexus between "liberalized depreciation and network investment."[29] The California CATV Ass'n.'s study is a classic example of comparing apples and oranges. The study compares net plant additions with depreciation expense. Nowhere does the study demonstrate that this comparison has any significance. In fact, "net additions" is the sum of gross additions and retirements. It is gross additions that reflect new investment in the telecommunications infrastructure. BellSouth is reinvesting virtually all of the cash flow from existing depreciation in new plant.

[28]California CATV Ass'n. at 2.

[29]California CATV Ass'n. at 4.

Retirements have nothing to do with the cash flow available for new investments.

Decisions on making new investments are based on economic analyses and market demand. Capital recovery through depreciation is the recovery of past investments. It is designed to match recovery of past investments over the remaining useful life of the plant. Investors are entitled to adequate capital recovery whether or not new investment is made. There is no requirement for a direct link between depreciation expense in a given period and gross plant additions during that period. The comparison made by the California CATV Ass'n. is meaningless and misleading, and should not influence the Commission's decision in this proceeding.[30]

In a desperate attempt to impede depreciation reform, California CATV Ass'n. makes the silly argument that LECs will so accelerate their depreciation rates that price cap regulation will be abandoned:

> ". . . if excessive depreciation rates severely depress earnings price caps may be prematurely abandoned, leaving ratepayers to bear the brunt of improperly increased depreciation expense <u>directly</u> in their rates."[31]

This assumes the LECs will: 1) artificially reduce

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[30]BellSouth notes that the consultants retained by the California CATV Ass'n. offer no credentials establishing any expertise in depreciation, and their "study" belies the existence of any such expertise.

[31]California CATV Ass'n. at 23 (Emphasis in original).

their earnings to perilously low levels, 2) forego the benefits of price cap regulation, and 3) convince the Commission not to exercise its prescriptive powers under Section 220(b) of the Communications Act to restore the carrier's depreciation rates to reasonable levels. Merely to state the hypothesis is to point out its absurdity. The Commission should reject the request of the California CATV Ass'n. to abandon depreciation reform.

III. The "range" options would produce less accurate depreciation and less savings than the Price Cap Carrier Option.

The range options proposed in the Notice are clearly second best solutions when compared with the PCCO. As several parties point out, the range options, being based on averages, may not be sufficiently wide to reflect accurately the depreciation rates appropriate for individual carriers. As Cincinnati Bell points out, ranges based on averages must include forward looking information and be at least two standard deviations wide to simply encompass the range of currently prescribed depreciation rates, much less rates that will permit carriers to recover their existing reserve deficiencies.[32] If the prescribed ranges are too narrow, or are mandatory, the Commission must allow for the rather than simplify, the depreciation process.[33]

Mandatory ranges will result in less accurate depreciation because of the "force fit" of individual carrier characteristics to values within the range, even if such values are not appropriate for a particular carrier or account. For these reasons, NARUC correctly recommends that either range option be optional for each applicable account of each carrier.[34] The PCCO avoids these potential problems by continuing to prescribe depreciation rates that are appropriate for each carrier and account.

IV. There is no support for the depreciation schedule option.

The record reflects unanimous disapproval of the depreciation schedule option. This option represents the furthest deviation from fundamental depreciation principles of matching expense to capital consumption.[35] It will almost certainly result in further reserve deficiency imbalances.[36] Should the Commission require tracking of accruals by vintages, even the apparent simplicity of this option disappears.[37] If the Commission elects to utilize

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[33]As the California PUC correctly notes, only by making the ranges optional can the Commission reasonably expect carriers to assume responsibility for any resulting reserve deficiencies. California PUC at 4.

[34]NARUC at 6-7, 9.

[35]California PUC at 6.

[36]SCA at 20.

[37]Cincinnati Bell at 13.

this method, it should be applied only to small, stable accounts on an optional basis.[38]

V. <u>The Commission should defer consideration of current period accounting for cost of removal and salvage to a later phase of this proceeding.</u>

NARUC identifies a number of complex issues that must be evaluated before a change in the current accounting for removal and salvage should be undertaken.[39] BellSouth agrees. If the Commission elects to move in this direction, it must adopt transition mechanisms similar to those adopted when the Commission converted station connections from capital to expense treatment. If the Commission wishes to pursue this option, it should initiate a separate proceeding to consider specific proposals for this transition.

VI. <u>Conclusion</u>.

Only the Price Cap Carrier Option will result in both more accurate depreciation and simplification of the process. Adequate safeguards exist, or can be readily adopted, to eliminate any perceived problems of potential abuse of this option. BellSouth recommends that the Commission adopt the Price Cap Carrier Option described in BellSouth's initial Comments and in these Reply Comments to become effective January 1, 1994.

Respectfully submitted,

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April 13, 1993

CERTIFICATE OF SERVICE

I hereby certify that I have this 13th day of April, 1993 serviced all parties to this action with a copy of the foregoing **REPLY COMMENTS** by placing a true and correct copy of same in the United States mail, postage prepaid, to those persons listed on the attached service list.

Susan V. Queen

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